## BRIEF IN SUPPORT OF PETITION.

### I.

### Opinions Below.

The District Court did not file a memorandum opinion but his findings of fact (R. 265) and conclusions of law (R. 292) are printed in full in the record.

The opinion of the Circuit Court of Appeals has not yet been officially reported but is likewise printed in full in the record (R. 338).

The opinion of the Circuit Court of Appeals denying the petition for rehearing (R. 351) is likewise printed in full in the record (R. 387).

### II.

### Jurisdiction.

The jurisdiction of this Court is invoked under Sec. 240 (a) of the Judicial Code as amended by Act of February 13, 1925 (28 U.S.C.A. Sec. 347A). The date of the decree of the Circuit Court of Appeals for the Sixth Circuit sought to be reviewed was April 21, 1944. The date of the opinion of said Circuit Court of Appeals denying the petition for rehearing was May 29, 1944.

### III.

### Statement of the Case.

A brief summary of the issues presented on this appeal has been set forth under the caption "Statement

of Matters Involved." As indicated, petitioner was purchasing accounts receivable from Belmont Candy Company for a period of two years prior to bankruptcy. Under the contract bankrupt made the collections and was required to remit in kind daily (R. 10b). Approximately four months prior to bankruptcy, bankrupt diverted funds collected by it on accounts assigned to petitioner (R. 269). Petitioner, as a condition to purchasing further accounts from bankrupt, required that one of its traveling auditors (who had discovered the diversion of funds) be stationed at bankrupt's premises to insure the forwarding to petitioner of all collections on accounts assigned to it. Petitioner continued to pay the auditor's salary but required that bankrupt pay his expenses at Memphis, Tennessee, which the contract contemplates (R. 10b). Some time thereafter this auditor severed his connection with petitioner and became employed by bankrupt. Petitioner continued to purchase accounts until approximately October 6, 1932 when another diversion of funds took place (R. 203), at which time it notified all of the debtors of the assignments to petitioner of their accounts and refused to purchase further accounts. The petition in bankruptcy was filed on November 1, 1932 (R. 1).

Neither the referee nor the District Court heard or saw any witnesses, the testimony consisting of three depositions and certain documentary evidence. Both courts below found that after July 1, 1932 petitioner's auditor was placed in full charge of bankrupt's business. Petitioner respectfully insists that there is no evidence in the record upon which such findings can be based. Be that as it may, and even assuming such findings to be correct (which we most strenuously insist is wholly disproved by the record) the theory of

both courts below respecting the major items in dispute is admittedly based entirely upon speculation and surmise. Both courts found that the contract was freely and fairly entered into and that the transactions of the parties were bona fide in every respect up to July 1, 1932; that the amount owing on July 1, 1932 of $12,214.20 was validly secured by accounts in the aggregate amount of $18,632.85 and that petitioner had a bona fide lien on all of those accounts. Both courts held that if this indebtedness of $12,214.20 was paid out of the accounts on hand July 1, 1932 there would be no recoverable preference. They both held further that the record did not segregate collections made after July 1, 1932 to show whether those collections emanated from accounts purchased prior to or subsequent to July 1, 1932. Both courts based their conclusions that a preference had been received on the theory that the indebtedness of $12,214.20 was paid exclusively out of accounts assigned after July 1, 1932. The record admittedly fails to show that such is the fact (R. 293). Therefore, the judgments below are based on the theory that the burden of proof was not upon the trustee to prove the factual foundations and all the elements of the preference alleged by him, but instead, was upon petitioner to *prove* that the unsupported allegations of the trustee were *not true*.

## IV.

### Specifications of Error.

The Circuit Court of Appeals erred:

1. In affirming the decree of the District Court.

2. In holding that where the record failed to show how much, if any part of the indebtedness of $12,214.20

was paid out of accounts assigned after July 1, 1932, it would be assumed that a substantial part of such indebtedness was paid out of subsequently assigned accounts and entering a decree on the basis that the entire indebtedness was therefore paid out of subsequently assigned accounts.

3. In holding that the trustee was entitled to recover any judgment from petitioner.

4. In holding that the burden of proof was *not* upon the trustee to prove the preference he alleged, but was on petitioner to *disprove* the unsupported *contentions* of the trustee.

5. In allowing interest at the rate of 6 per cent per annum from the date of bankruptcy.

**Summary of Argument.**

I. The decision of the court below is in conflict with the decisions of the Circuit Court of Appeals of the District of Columbia and the decisions of the Circuit Court of Appeals for the 2nd and 9th circuits.

A. The basis of the decisions below is that petitioner received a preference because the indebtedness owing to it on the day four months prior to bankruptcy was repaid wholly out of security assigned within the four months period.

B. The record admittedly fails to show whether any part of such indebtedness was paid out of subsequently assigned accounts.

C. The courts below held that upon the trustee making unsupported allegations, the burden was upon petitioner to *disprove* such allegations; that if the record did not contain any evidence on the subject, the trustee's unsupported allega-

tions would be assumed to be true, despite petitioner's denials.

D. The reported decisions are directly contrary to the holdings of the courts below.

E. The burden of proof is upon the trustee to establish every element of the preference he alleges.

II. The decision of the court below rests upon two unsupported presumptions—the second built upon the first.

A. The authorities all hold that a presumption arises that payments made by a bankrupt to creditors are valid.

B. The courts below refused to apply the above principle of law; instead, two presumptions were indulged in, the second built upon the first. These presumptions are:

(i) that a substantial part of the secured indebtedness owing petitioner on the day four months prior to bankruptcy was paid out of security assigned within the four month period.

(ii) therefore the *entire* indebtedness was paid exclusively out of security assigned within the four month period.

C. There is admittedly no record support for either presumption.

D. The courts below have substituted two unsupported presumptions for a substantive rule of law.

## ARGUMENT.

### I.

**The decision of the court below in this case is in conflict with the decision of the Circuit Court of Appeals for the Second Circuit in the case of Israel v. Woodruff, 299 Fed. 454, in conflict with the decision of the Circuit Court of Appeals for the District of Columbia in the case of Brown, et al. v. Christman, et al., 126 Fed. (2d) 625, and in conflict with the decision of the Circuit Court of Appeals for the Ninth Circuit in the case of Stennick v. Jones, et al., 282 Fed. 161.**

As appears from the statement of facts, the vital question involved on this record is whether petitioner secured a preference by receiving payment of an indebtedness admittedly owing to it on July 1, 1932 in the sum of $12,214.20 (to repay which it had valid assignments of accounts aggregating $18,632.85). The basis of the decisions below was that such preference was received because said indebtedness was paid out of subsequently assigned accounts exclusively. We shall assume for the sake of the argument that as a legal proposition petitioner would have received a recoverable preference if said indebtedness had been paid entirely out of subsequently assigned accounts. *The record admittedly fails to show whether any part of the indebtedness was paid out of subsequently assigned accounts.*

Who is to be charged with this crucial absence of record proof? Petitioner submits that it is axiomatic that the burden is on the trustee to establish, by com-

petent evidence, every element of the claimed preference. This he admittedly failed to do. But both courts below held that in the instant case, the trustee had no burden to establish his claims. They held that upon the trustee making his unsupported allegations, the burden was upon respondent petitioner to *disprove* the allegations; and that if the record did not contain any evidence on the subject, the trustee's unsupported allegations would be assumed to be true, despite petitioner's denial.

The decision of the court in such respect is an unwarranted departure from established principles, finds no precedent to support it, and is in direct conflict with the decisions of three Circuit Courts of Appeal—the Second and Ninth Circuits, and the District of Columbia.

The identical problem came before the Second Circuit in *Israel* v. *Woodruff,* 299 Fed. 454. The trustee in bankruptcy there sought to recover alleged preferential payments made prior to bankruptcy. The creditor had loaned money upon the security of certain potatoes in storage and had arranged with bankrupt to sell the potatoes for the creditor's account. The potatoes were sold and creditor's loans paid in full. (The analogy is striking since in the instant case accounts receivable were sold to petitioner, but under the contract bankrupt was allowed to make all collections, turning them over to petitioner as received.) The court held that in order to recover, the burden was upon the trustee in bankruptcy to show that an unlawful preference had been received and that the burden was on the trustee to show that the payments were *not* made from the proceeds of the sale of potatoes on which the creditor had a valid lien. The trustee contended (as is shown on page 457 of the opinion) that the burden was upon

the creditor to trace the funds realized and paid to it by the bankrupt and to show that all of such funds came exclusively from the sale of potatoes on which the creditor had valid liens. The court rejected this contention, saying that the money had been paid and the pledge satisfied and that the burden was upon the trustee, not on the creditor. This is the precise question here presented. Although conceding in its opinion that the burden of proof generally was upon the trustee in bankruptcy (Op. R. 340) the court below held that the burden was not upon the trustee but was, instead, upon the creditor to show the source of the funds paid to it by bankrupt.

The decision of the court below is likewise contrary to the decision of the Circuit Court of Appeals for the District of Columbia in *Brown, et al* v. *Christman, et al,* 126 Fed. (2d) 625. That was not a bankruptcy case but the principle decided is identical. One Hedges, a real estate broker, had collected rents for numerous property owners whom he represented, and deposited them in a special rent account. At the time of his death Hedges owed about $21,000 to various property owners for rents collected, but only had in his special rent account the sum of $2795.41. Plaintiffs, consisting of property owners having about $10,500 coming from Hedges, sued the latter's administratrix to impress a lien on the funds that were in the special account and prayed that they be distributed to them pro rata. Defendant insisted, among other things, that plaintiffs had failed to show that the funds in the hands of the administratrix were augmented by the trust funds, and that the burden of proof was on plaintiffs to show that no part of the account consisted of anything *other than* trust funds. Rejecting this contention, the court held, page 630:

> "There is no evidence in the record to suggest that Hedges deposited any of his own money in the rent account—apart from his interest in the collections —during the period in question. *The burden was upon the estate, therefore, to show that any part of the fund was not of a trust character.*" (Italics supplied)

The decision in the instant case is likewise contrary to the decision of the Ninth Circuit Court of Appeals in *Stennick* v. *Jones, et al,* 282 Fed. 161. That was an action by a trustee in bankruptcy to recover the value of certain property alleged to have been the property of bankrupt and to have been taken by defendants. A question arose as to what property, if any, not belonging to defendants was taken by them or delivered to them by bankrupt. On this question the court held, page 164:

> "The burden of proof was upon the plaintiff to sustain his claim that personal property belonging to the bankrupts, not included in the contract and not paid for out of the $215,000, was taken by the defendants on May 12, 1914, at the time of the surrender of the property under the forfeiture clause of the contract."

In other words, where bankrupt had delivered property to the creditor and where the trustee claimed that defendant was not legally entitled to receive that property, the court held that the burden was upon the trustee to establish the identity and value of the property so taken, and that it was property which defendant was not entitled to receive.

The decision in the instant case is exactly to the contrary. The court has held that where the record fails to show the source of the collections delivered by bank-

rupt to petitioner the court will presume that the entire indebtedness owing July 1, 1932 was paid out of subsequently assigned accounts. This does violence to all of the decisions of this Court and all of the Circuit Courts of Appeal, which places the burden of proof upon the trustee in bankruptcy who seeks to recover an alleged unlawful preference. The decision is a remarkable departure from established procedure. It presumes that unsupported contentions are true unless *disproved* by respondent. It places the burden of proof on the defendant instead of the plaintiff. On this theory the plaintiff makes contentions and rests; unless defendant *disproves* plaintiff's charges, the charges will be presumed to be true, notwithstanding defendant's denial.

In the instant case, the trustee in bankruptcy was asserting substantive, affirmative causes of action against petitioner. Every authority on the subject requires the trustee to establish the claimed preference and every authority places the burden upon the trustee to prove every element of the alleged preference. The authorities are legion and are collected in Collier on Bankruptcy, 14th Ed. Vol. 3. Sec. 60.62, page 1040 and following, and in Vol. 4, Sec. 67.43, page 363 and following. This burden never shifts from the party having the affirmative of the issue. *Matter of Locust Bldg. Co.*, 299 Fed. 756, 763 (C.C.A. 2) (Cert. den. 265 U.S. 590; 68 L. Ed. 1195). That court stated, page 763:

> "The burden of proof never shifts from the party having the affirmative of the issue. But while the burden of proof does not shift, yet during the progress of the proceeding the burden of going forward with the evidence to rebut a prima facie case may shift. All this we pointed out in Cowen Co. v. Houck Mfg. Co., 249 Fed. 285, 161 C.C.A. 293. In the proceeding by the trustee for permis-

sion to sell the property covered by the mortgages free and clear of all liens, the burden of proof and the burden of evidence also was on the trustee in the first instance to establish the invalidity of the mortgages. The burden of proof continued with the trustee throughout, and the burden of evidence until at least he made out a prima facie case. United States v. Iron Silver Mining Co., 128 U.S. 673, 9 Sup. Ct. 195, 32 L. Ed. 571; Moffat v. United States, 112 U.S. 24, 5 Sup. Ct. 10, 28 L. Ed. 623. But we are quite unable to see, upon the evidence in this record, that a prima facie case was made out against the Trust Company, and in this case, in our opinion, the burden of evidence, like the burden of proof, remained upon the trustee throughout."

## II.

**The fundamental basis of the decision below rests on a presumption admittedly unsupported by the record, and upon another unsupported presumption built upon the first presumption.**

As we have above pointed out, and as the Circuit Court of Appeals stated in its opinion (R. 349) the controlling question on this record is the source of the collections made between June 30, 1932 and October 6, 1932. The liability of petitioner is predicated wholly upon the *presumption* that the indebtedness of $12,214.20 owing petitioner June 30, 1932 was not paid out of the security petitioner had on that date for that indebtedness (accounts aggregating $18,632.85), but was paid exclusively and entirely out of the proceeds of accounts assigned subsequent to that date.

It is admitted on the record that all of the collections on all accounts during the period from June 30, 1932 to October 6, 1932 were made by the *bankrupt* and for-

warded to petitioner. That was the date after which petitioner purchased no further accounts from bankrupt and several days thereafter petitioner gave notice to the debtors to pay the accounts directly to it.

It is fundamental bankruptcy law that "A presumption arises that payments made by the bankrupt to creditors are valid, and the trustee seeking to recover such payments must overcome this presumption by adequate proof of a voidable preference." Collier on Bankruptcy, 14 Ed. Vol. 3, Sec. 60.62, page 1040 and the numerous authorities cited in footnote 3 on page 1044. Thus, in the absence of any proof to the contrary, a legal presumption arises that all payments made by bankrupt to petitioner, on account of bankrupt's indebtedness to petitioner, were valid.

In *Israel* v. *Woodruff,* 299 Fed. 454 (C.C.A. 2) the court said (page 457):

> "It is argued that the burden is upon the appellees to trace the funds realized from the potatoes. But the money has been paid and the pledge satisfied. The burden is upon the appellants to show that appellees have received an unlawful preference. *The payments by the bankrupt were consistent with honesty on their part, and the burden was on the appellant to show the payments were not made from the proceeds of the sale of the potatoes.* This burden it has not sustained. *If one mixes trust funds with his own, the same will be treated as a trust property, except so far as he may be able to distinguish what is his own. National Bank* v. *Insurance Co.,* 104 U.S. 67, 26 L. Ed. 693." (Italics supplied)

Instead of applying this well recognized and established legal presumption the court below held that since there was no evidence in the instant record from which

it could be determined what part of the collections made after June 30, 1932 were made out of accounts on hand June 30, 1932, and what part out of accounts purchased by petitioner thereafter, it would be *presumed* that a substantial part of the indebtedness of $12,214.20 owing petitioner on June 30, 1932 was paid out of the proceeds of accounts assigned thereafter. This presumption has no supporting authority. The court, however, went further and built another presumption upon the first presumption. It then presumed that if a substantial part of the indebtedness owing June 30, 1932 was paid out of subsequently assigned accounts it would be further *presumed* that the entire indebtedness owing June 30, 1932 was paid exclusively out of accounts assigned subsequent to that date. These presumptions are indulged in by the court, notwithstanding the admitted fact, as found in the opinion of the Circuit Court of Appeals (R. 349), that the collections after June 30, 1932 exceeded 100 per cent of the face amount of the aggregate of all accounts purchased after June 30, 1932 by some $5,000.00. (Actually, it affirmatively appears from the record that the collections after June 30, 1932 exceeded 100 per cent of the aggregate face amount of all accounts purchased after that date by over $10,000.00. See Point II of the Petition for Rehearing, R. 362-372.)

This court has often decided that presumptions must be based upon record proof. Mr. Justice Holmes, in *McFarland* v. *American Sugar Refining Co.*, 241 U. S. 79, 60 L. Ed. 899, stated, page 86:

> "It is 'essential that there shall be some rational connection between the fact proved and the ultimate fact presumed, and that the inference of one fact from proof of another shall not be so unreasonable as to be a purely arbitrary mandate.' Mobile, J. &

> K. C. R. Co. v. Turnipseed, 219 U.S. 35, 43, 55 L. ed. 78, 80, 32 L.R.A. (N.S.) 226, 31 Sup. Ct. Rep. 136, Ann. Cas. 1912A, 463, 2 N.C.C.A. 243. The presumption created here has no relation in experience to general facts."

The same court which decided the case below stated this proposition very succinctly in *Socony-Vacuum Oil Co.* v. *Oil City Refiners,* 136 Fed. (2d) 470 (Cert. den. 88 L. Ed. 207) as follows, page 474:

> "Presumptions of fact which the law recognizes must be immediate inferences from the facts proved and must be such as sensible men influenced by observation, experience and reason, would draw from clearly established facts."

Their conclusion in the instant case is irreconcilable with the language just cited from their former opinion. The opinion of the court below bases one presumption on another—a practice long condemned by this court. *United States* v. *Ross,* 92 U. S. 281, 23 L. ed. 707; *Looney* v. *Metropolitan R.R. Co.,* 200 U. S. 480, 50 L. ed. 564; *Manning* v. *John Hancock Mut. L. Ins. Co.,* 100 U. S. 693, 25 L. ed. 761.

The conclusion of the court below admittedly finds no support in the record. The decision of the Circuit Court of Appeals specifically points out that it cannot be determined from the record how much of the collections made after June 30, 1932, were on accounts on hand on that date, or how much emanated from accounts assigned subsequent thereto. The first presumption indulged in by the court, that a substantial part of the indebtedness owing June 30, 1932 was paid out of subsequently assigned accounts, is, therefore, a presumption which has no rational connection with any fact

proved in the case. Indeed, it is contrary to the record which shows that over $10,000.00 was collected after June 30, 1932 over and above 100 per cent of the aggregate face amount of all accounts assigned after June 30, 1932. The result, not by way of presumption, but by way of deduction from facts actually established and proved without contradiction, and a deduction which all sensible men influenced by observation, experience and reason would draw from the established facts, is that at least $10,000.00 was collected on the accounts already on hand June 30, 1932. Therefore, at least $10,000.00 of the indebtedness of $12,214.20 owing June 30, 1932 must necessarily have been paid out of accounts on hand June 30, 1932 (petitioner admittedly having had valid assignments of accounts aggregating $18,632.85 on hand June 30, 1932 to secure its indebtedness).

It is obvious, therefore, that the court below has not only indulged in a presumption which finds no support in the record, but has indulged in a presumption which is exactly contrary to the admitted facts established without contradiction in the record. Having indulged in that presumption (that a substantial part of the indebtedness owing June 30, 1932 was paid out of subsequently assigned accounts) the court indulged in a second presumption, built entirely on the former, that the *entire* indebtedness owing petitioner on June 30, 1932 was paid out of subsequently assigned accounts. This is the gist of the holding of the court below, its opinion being grounded squarely on that point. Thus the court below has substituted two presumptions, both of which, we submit, are improperly drawn, for a substantive rule of law. The court has thus concluded that as a matter of law it will be presumed that a secured indebtedness owing more than four months prior to

bankruptcy, and repaid by the bankrupt within the four months period, was improperly paid out of proceeds to which the creditor was not entitled; and this without any record proof to support it, and, as a matter of fact, despite the record to the contrary. It is respectfully submitted that in so holding the court below has decided an important question of law in a most untenable way, in conflict with all applicable decisions of this court and the weight of authority generally. It is further submitted that the court in so doing has so far departed from the accepted and usual course of judicial proceedings to call for an exercise of this court's power of supervision.

The question presented is a vital one of great importance to not only financial institutions throughout the country, but to all business establishments who now do or who may hereafter require financing of this type. This court has already taken notice of the extent of account receivable financing in this country. In *Corn Exchange National Bank & Trust Company* v. *Klauder* 318 U. S. 434; 87 L. ed. 884, this court observed (p. 437) that account receivable financing is a business of large magnitude. In a foot note to its opinion in that case, reference was made to Saulnier and Jacoby, Accounts Receivable Financing (National Bureau of Economic Research, 1943) where an estimate was made that in 1941 commercial finance companies advanced $536,000,000.00 on this type of financing and commercial banks, an additional $952,000,000.00. Financial institutions will not be able to continue account receivable financing if courts can draw presumptions such as those indulged in by the court below. If it is to be presumed that a secured indebtedness owing four months prior to bankruptcy was paid in all cases out of subsequently assigned accounts, without record proof to establish such presumption, and

particularly in instances where the record proof is to the contrary, it is obvious that a commercially recognized and useful method of financing will have to be eliminated and business establishments throughout the country deprived of their opportunity to secure needed financing on this type of security. A security transaction which has always been recognized and fully enforced by all of the courts of this country, would be converted by the device of presumptions into a situation resulting in all cases in a recoverable preference to the extent of the amount of the indebtedness owing on the day four months prior to bankruptcy. Governmental agencies like the Reconstruction Finance Corporation, as well as all of the banks and other large financial institutions of the country, will necessarily have to eliminate or largely curtail this type of financing, the economic need for which is so eloquently established by the extent of financing of this type done throughout the country.

## CONCLUSION.

We respectfully submit that the decision of the court below is a revolutionary departure from recognized authorities and one which finds no justification in the law. The problem presented by this decision is of immense importance and we therefore respectfully submit that it is a matter which should be reviewed by this Honorable Court.

Respectfully submitted,

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